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Behind the Scenes at

Equity Funding

By ALBERT HUDES/Executive Editor

On Monday, April 2, Dave Amsterdam, a partner in the Los Angeles office, received a call at 9:15 a.m. at a client's office. The call was from Irwin Buchalter of the law firm of Buchalter, Nemer, Fields & Savitch, a Los Angeles firm specializing in bankruptcy. Buchalter said that his firm had been called in on Friday concerning a conservatorship for Equity Funding Corp. of America, one of the major companies in the insurance industry with a reported \$6.5 billion of policies in force. All that Dave Amsterdam knew at that time about the company was that two weeks before, Equity Funding had announced that its earnings for 1972 showed an increase of 17 percent over 1971 and shortly after that the New York Stock Exchange had halted trading in Equity Funding shares. (Later, the proof sheets of the company's unpublished 1972 annual report showed year-end assets at \$737 million, stockholders' equity at \$243 million, and profits for the year of \$22.6 million.)

What Dave could not know was that there was in process a sequence of events which would culminate in a scandal that would rock the financial world.

Buchalter asked Dave if Touche Ross could take on an engagement which would require about 30 people immediately and sketched out the dimensions of the problem. Time was running short and he needed an answer by 4:00 p.m.

Dave discussed Buchalter's request with Robert Dodson, partner in charge of the Los Angeles office, and Norman Grosman, the partner on the Beneficial Standard Insurance Company account. Bob called Managing Partner Russ Palmer, who promised the Los Angeles office any support it needed. After a few more calls and a request for additional information describing the magnitude of the engagement, Buchalter was told Touche Ross could do the job.

Touche Ross was appointed auditors by U.S. Federal Judge Harry Pregerson, in the court's conservatorship of the company. Several days later, on April 5, Equity Funding filed for reorganization under Chapter X of the Federal Bankruptcy Act. Touche Ross was again appointed, even before the trustee was found. An unusual arrangement, but it was deemed necessary because of the need for immediate work to be done, particularly for computer security. The engagement was reconfirmed after the court

The Touche Ross audit staff, comprising 68 professionals assembled from 20 offices, has been working at Equity Funding headquarters office since April.

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had appointed Robert Loeffler as trustee. Touche Ross was separately appointed auditors of the subsidiary, Equity Funding Life Insurance Company (EFLIC), by the Illinois and California Insurance Departments, which have conservatorship responsibilities for this company.

According to the court order, Touche Ross would be responsible for examining the balance sheet of Equity Funding as of April 5, 1973, the day it went into bankruptcy and performing such other services as needed by the trustee.

Organizing for the Job

As soon as our appointment was confirmed, the first order of business was to staff the job.

Norm Grosman, because of his general background and his experience in the insurance industry, was named partner in charge of the engagement and would devote most of his time to it.

Steve Finney, a partner in the Chicago office, was appointed "cold review" partner. This was a departure from the Touche Ross quality control system where a partner from one office was selected, usually at the end of an engagement, to review the work of another office. Steve was selected from the outset so that he could review the engagement on a continuing basis, including the audit program and other steps in the process of the job. Steve has been averaging about one day a week in Los Angeles on this engagement.

The next step was to set up Touche Ross audit teams to conform with the operations of Equity Funding. Once the needs were determined, Norm and Bob Dodson combed the Los Angeles office to see if the particular expertise was there, and if it was, if it could be reallocated for an indefinite time.

For purposes of creating staff, Equity Funding headquarters activities were identified as follows:

- Parent company.
- Life insurance.
- Insurance general sales agency.
- Cattle.
- Security broker/dealer.
- Real estate.
- Oil and gas.

In addition to the headquarter companies, Equity Funding operations included a sizeable insurance company in Seattle, a savings and loan association in Los Angeles, and a bank in Nassau (Bahamas). This part of the engagement was staffed separately and administered in those locations.

The Touche Ross operation at Equity Funding was divided into two audit groups under Norm Grosman. William Worthen, a manager in the Los Angeles office, was to be in charge of the overall administration of the audit of the parent company and all the Los Angeles companies, with the exception of Equity Funding Life Insurance Company (EFLIC). He would supervise the firm's work at the parent company and at the general insurance agency, which was selling and financing life insurance and mutual funds.

Nelson Gibbs, a partner in the Los Angeles office, was given the responsibility of supervising the Touche Ross operations for EFLIC. Other partners and managers, mostly from the Los Angeles office, would work on the other Equity Funding subsidiaries.

A third unit, the computer audit project team, was organized under Carl A. Pabst, a manager who heads the audit EDP operations in Los Angeles. This group was organized to conform to the two audit groups and functioned as a captive "service" bureau to them.

One of the first activities for the Los Angeles office was

Carl A. Pabst (Los Angeles), manager of the computer audit project with Richard Webb (Executive Office), and Thomas Beck (Detroit).

the actual business of lining up professionals to staff the jobs. The Los Angeles office, naturally, was the initial source of manpower, and it was able to assign 20 full time and part time people almost immediately. "The Los Angeles office alone could not have met the demands of this engagement," Bob Dodson pointed out, "even if we had had more lead time. Younger staff assistants were fairly easy to get, but assembling experienced seniors was more difficult."

The support promised by Russ Palmer was quickly made available and a call went out to the other offices for qualified people. In stressing the importance of finding the best people for the job, Russ said, "We were selected by our reputation, but we will be judged by our performance."

The one-firm concept was put to the test. How quickly could the job be staffed and individuals made available to Los Angeles? The results demonstrate the success of that concept.

Within a short time, a staff of 68 professionals with the necessary qualifications were gathered from 20 Touche

Norm Grosman, partner in charge of the engagement.

Moonlighting on the Job—or, STRATA by Starlight

The first two weeks at Equity Funding was a period of high tension and drama. Most of the Touche Ross work took place in the computer area, and no one knew exactly what would be happening to the computer operations or to the computer files.

Initially, according to Carl Pabst, a few STRATA-trained people took over custody of the approximately 4,000 computer tapes, trying to learn how the company's computer operations functioned. STRATA is a generalized computer software program, developed by Touche Ross, that allows the auditor to locate, retrieve, and manipulate information in a client's computer files. It was used in the Equity Funding audit more extensively than ever before.

During this first stage, there were two separate and almost conflicting conditions: the establishment and maintenance of adequate security over the computer installation (which operated 24 hours a day) and the attempt to recreate normal computer operations to support on-going company activities. In addition, security procedures had to be established before Equity Funding's systems analysts and programmers could return. (They were not allowed in during this period.) By April 23, the tapes were secured and files needed for on-going operations had been dupli-

cated, so that the Equity Funding people could resume operation on the IBM 370-145.

From then on, the Touche Ross computer audit project team concentrated on developing STRATA applications to support the other audit groups. To do this, it took over the third shift of the computer operations — 2:00 a.m. to 8:00 a.m. and weekends. Carl Pabst points out that the STRATA people on loan from other offices rarely saw the sun in sunny California. "This is the only time," Carl said, "that moonlighting was not only approved by the firm, but was programmed."

By early June, the staff had grown to 27 professionals, and management control procedures over EDP STRATA development activities had been established along with new standards for its use and documentation. The work performed was in response to the demands of the other audit groups. STRATA application encompassed seven major areas of work, including EFLIC and several other subsidiaries.

To date, the computer audit project team has completed more than 7,000 man-hours, clocking 1,000 hours of computer time, and generating in excess of 2,000 STRATA programs.

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Ross offices around the country.

Finding these people was only part of the task of creating a team. Because of the extended duration of the engagement, many wives and families were also involved. And since landlords are sometimes reluctant to sign short leases or take children, housing became a real problem. The Los Angeles office organized a small housing agency, booking rooms at nearby hotels and tracking down houses or apartments where the tenants were willing to sublease. One supervisor found accommodations in an ex-movie mogul's Hollywood mansion.

Scope of the Engagement

Much has been written about Equity Funding and what seems to emerge from the publicity is some real information and some sensational speculation. The purpose of this article is not to add to either the information or to the

speculation, but to indicate the nature of the engagement.

The Equity Funding engagement is not a simple bankruptcy. It is complicated since government agencies have been brought into the picture because of the allegations of fraud.

By order of Judge Harry Pregerson, Robert Loeffler was named trustee to take over the operations of Equity Funding for the purpose of reorganizing under Chapter X and rehabilitating the company. EFLIC, the subsidiary in which massive fraud has also been alleged, is being run by J. Carl Osborne, appointed by the Illinois Insurance Department since EFLIC is domiciled in Illinois. (Because EFLIC is headquartered in California, the California Insurance Department is also concerned.)

In addition to the two regulatory agencies, investigatory agencies are concerned with possible fraud: the FBI is involved; the U.S. Attorney is concerned about the possibility of a criminal case against certain officers of the company; the Los Angeles regional office of the SEC is conducting its own inquiry; the Division of Corporate Reorganization under Chapter X bankruptcy proceedings is representing the shareholders; and the Post Office Department is investigating possible mail fraud.

Touche Ross reports directly to the court through the trustee and to the Illinois Insurance Department through its conservator. However, there is extensive cooperation between Touche Ross and the investigatory agencies.

The Engagement Is Underway

"The first two weeks," Norm Grosman said, "were total bedlam." The court determined that Touche Ross should secure the computer room and take physical custody of all tape files. It took two nights and one day to inventory, box, and seal the files. The files were moved out of Equity Funding over Easter weekend and are now secured in a vault accessible to only Touche Ross. After they were moved, the files needed for regular processing had to be duplicated. There could be no erasing on tapes generated before March 30. Files generated after March 30 were also frozen but are being released gradually. "Before we would allow these files to be returned to the company," Norm said, "we had to review the systems documentation to determine which tapes would be required for future audit purposes." Other files were released under a reasonable retention schedule.

The parent company was not an operating company, but it originated a series of major transactions, such as long-term debt borrowings and "special receivables."

Touche Ross people sometimes arrive before the offices are open.

262 cattle in this feed lot are counted by punching pinhole in each image, tracing pattern of pinholes on back, and counting.

Each is a case study in itself and the audit work required that Touche Ross carry out "extended" audit procedures to check carefully these transactions. To do this, the staff had to:

- Examine voluminous files and records.
- Contact people outside the company (the other party to the transaction).
- Interview people still with the company.
- Exchange vital information with investigating agencies.

Extended audit procedures are a necessary feature of this kind of audit. Sampling used in the normal audit is inadequate under circumstances where fraudulent transactions are suspected. Furthermore, the bank statements found in the files cannot be relied upon because they might be fictitious. Photocopies must be obtained from the banks to confirm file copies. Checks must be examined; deposits must be verified; and bank debit and credit memoranda must be reviewed.

The cash/inter-company transactions are being examined on a centralized basis, with the same detail through extended audit procedures, and as an entity since the function operated as an entity.

This philosophy of extended audit procedures was applied with greatest emphasis in operations called General Agencies, which controlled the "funding programs," the combined mutual fund and life insurance sales program. The plan allowed a customer to participate in the program by buying fund shares every year, then borrowing against them to pay the premiums on a life insurance policy. The funding program was for ten years, and at that

time, in theory, the customer could sell enough shares to pay off the loans.

There were about 20,000 funded loan accounts on record and each one of these had to be checked individually. These accounts were pulled out of the company's computer files by STRATA (see story on page 15). Each account that was identified was sent a confirmation form specially designed to conform to the STRATA confirmation print program, which included pertinent information on each transaction and which requested confirmation on the loan balances and mutual fund shares. (The returns were examined individually and those which disagreed with the records were removed.) The confirmation replies were then summarized by STRATA and the updated detail files maintained.

The transfer agents for the mutual funds have been very cooperative and have given the project team their tapes or other information to be compared with STRATA tapes taken from Equity Funding computer files. This arrangement facilitates accuracy and speed in confirming the existence of securities and balances of accounts.

Touche Ross has also been able to confirm the existence of the actual mutual fund shares with the two bank repositories.

Thus, the customer confirms what shares he owns, the transfer agents confirm what shares are registered in the customer's name, and the banks confirm what shares they are holding as collateral.

The audit of the company's cattle operation, Ankony Angus Corp., and tax-shelter partnerships, is well underway and their assets essentially confirmed. In counting cattle, Touche Ross added a new technique to its extended

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audit procedures. One of the techniques used in making an accurate inventory of cattle, is to photograph them from the air in their feeding areas. A pin prick is made on each face in the photograph; each is marked in red on the reverse side, and then counted. (A far more reliable, safer method than trying to ride among the herds with STRATA reports strapped to saddles, according to one of our auditors who fell from his horse during a roundup.)

Equity Funding operated as its own securities broker dealer, and the audit of this activity was relatively simple since the operation itself was not complex; a mutual fund management company (EFC Management Corp.) operated as a profit center and has already been sold to a New York group.

The audit of the real estate operations of Equity Funding Development Corp. is virtually completed. The physical existence of properties (mostly apartment houses) had to be verified and title reports checked to determine who sold them to the company. A \$17 million construction-investment operation in Arizona and California is being run by its previous management. Touche Ross had to re-

view the evaluation of profitability because Equity Funding guaranteed cash flow to investors in the real estate operations.

The oil and gas audit is completed. Equity Funding's operation consisted of participating in some drilling in Ecuador, Ethiopia, and Israel and managing proprietary oil and gas limited partnerships for tax shelter investors.

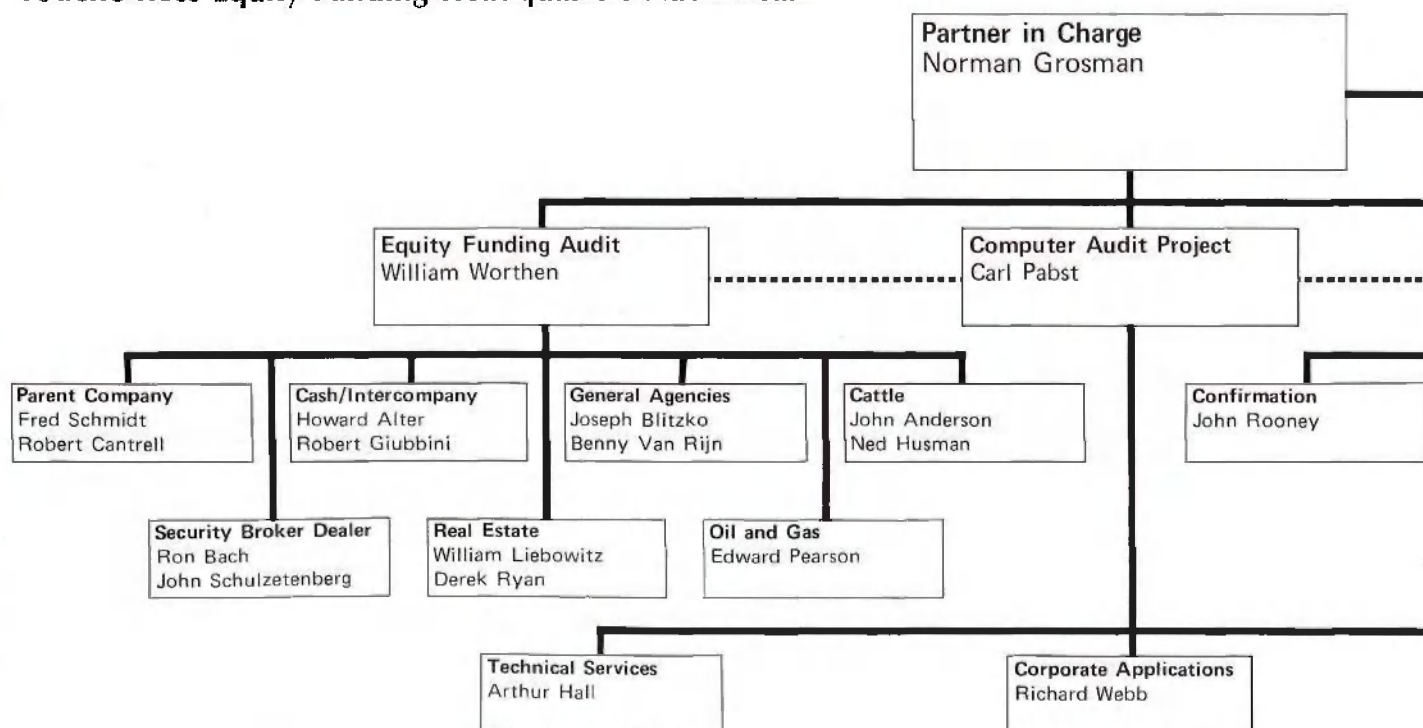
Equity Funding Life Insurance Company

The insurance business, naturally, represented the bulk of the company's operations and was conducted by EFLIC and two other free standing insurance companies.

The audit for EFLIC is obviously extremely complex, both because of the unusual aspects of the business and because EFLIC is under suspicion of massive fraud.

Touche Ross is not charged with the responsibility for investigating for fraud (this is being done by the federal and state investigatory agencies), but in performing the audit, it must try to separate the fraudulent and valid activities.

Touche Ross Equity Funding Headquarters Audit Team



EFLIC is still in business. It is not permitted to sell new insurance but is servicing its existing policyholders, under the combined conservatorship of the Illinois and California Insurance Departments. The firm's assignment with EFLIC is threefold:

- To assist EFLIC in developing a list of good "in-force" policies;
- To recreate transactions with reinsurers; and
- To carry out a complete audit as of the date of the conservatorship.

EFLIC reported that it had more than 90,000 policy holders, and Touche Ross is attempting 100 percent confirmation. EFLIC employees were able to make a tentative breakdown of approximately 60,000 "fictitious" policies. About 15,000 policies in the files have no names or addresses for the insured or have incomplete addresses. Of those 60,000 policies thought to be fictitious, about 45,000 confirmations were sent out. A significant number of these were returned from the post office as undeliverable. On the basis of the returns, 20,000 second requests were

mailed in mid-August. If these bring in no response, and in light of the evidence and additional computer analysis, the assumption will be made that they are indeed fictitious.

Of the approximately 30,000 policies believed to be "good," confirmations were also mailed on a 100-percent basis. Where there is no response, additional effort is being made for substantiation by matching transactions from other sources.

Vital to EFLIC is the determination of the good in-force policies held by reinsurers. EFLIC had entered into coinsurance agreements with other insurance companies by which the coinsurers would make a substantial payment for the policies and also assume responsibility of setting up reserves to cover them.

Touche Ross has to recreate these reinsurance transactions to determine if they are supported by non-existent policies or good policies.

The financial statement of EFLIC for 1972 listed as its major asset \$24.5 million in bonds, almost all of which are assumed to be non-existent; revenues of \$32.6 million (which included premiums from non-existent policies and investment income from non-existent bonds); and operating expenses of \$27.8 million. Determination of the actual financial condition of EFLIC will have to wait for the completion of the audit. In the meantime, every major inter-company transaction (between EFLIC and the parent company) must be examined. The audit team made a detailed computer analysis of all inter-company and parent company cash transactions. From this analysis, key transactions were selected for outside substantiation.

The massive audit of Equity Funding started six months ago with the examination of the balance sheet as of April 5. It is painstaking, meticulous, and time-consuming effort.

The task will be over soon. The facts will emerge and the company's viability will be determined.

The public in general, and the accounting profession in particular, would be ill-served if it turned away from this engagement without paying attention to the lessons to be learned.

Robert Dodson pointed out that we are operating in a changing environment of audit control and that our traditional assumptions no longer apply. "At one time," he said, "we looked to the division of groups as a protection against fraud. With the advent of computers, the separation of groups is disappearing and a small group of men, or even one man, can conceive a massive fraud by simple programming devices. This can lead to significant changes in accounting where a computer is involved." ▲

